

DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 05-0506
Gross Income Tax and Adjusted Gross Income Tax
For the Years 2001-2002

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ISSUES

I. Gross Income Tax--Interstate Commerce

Authority: 45 IAC 1.1-3-3

Taxpayer protests the assessment of gross income tax on certain sales that Taxpayer maintains were made in interstate commerce

II. Adjusted Gross Income Tax—Royalty Expenses

Authority: Ind. Code § 6-3-2-2

Taxpayer protests the disallowance of deductions for royalties paid to a sister corporation, along with the disallowance of net operating loss carryforwards from years in which the statute of limitations has passed.

III. Tax Administration--Negligence Penalty

Authority: Ind. Code § 6-3-4-4.1; Ind. Code § 6-8.1-10-2.1

Taxpayer protests penalties based on Taxpayer's failure to make estimated tax payments.

STATEMENT OF FACTS

Taxpayer is a company engaged in the sale of food and food service supplies. Taxpayer operates three sales offices, three transit and delivery stations, and thirteen retail stores in Indiana. Taxpayer has two types of operations, which will be described as grocery-type operations and restaurant-type operations. Taxpayer's grocery-type operations are ones in which customers enter Taxpayer's retail stores and purchase food and other related items for personal or group use. Taxpayer's restaurant-type operations are ones in which Taxpayer delivers items ordered by restaurants, cafeteria, and similar customers. Taxpayer excluded some restaurant-type sales made to Indiana customers from its gross income for gross income tax purposes. However, upon audit of Taxpayer, the Department concluded that the sales were connected with an Indiana business situs and assessed gross income tax.

In addition, Taxpayer deducted payments made to a sister corporation (hereinafter “TP Brands”) which Taxpayer paid for the use of intellectual property. For the period from 1998 to 2000, the deduction resulted in a net operating loss that Taxpayer carried forward to 2001 and 2002. The auditor disallowed the net operating loss carryforwards from 1998 to 2000 that Taxpayer used in 2001. For 2001 and 2002, the Department disallowed Taxpayer’s deductions for payment to TP Brands and assessed additional adjusted gross income tax.

Further, Taxpayer claimed a deduction for a special depreciation allowance permitted under federal law but not permitted under Indiana law. Taxpayer has conceded this issue.

Finally, Taxpayer protests the imposition of penalties imposed for underpayment of estimated taxes determined to be due. Taxpayer protests that the Department made its penalty assessment based on calculations that used Taxpayer’s amount of tax as determined by the Department’s audit as a basis for determining the amount of tax due rather than the amount listed on Taxpayer’s return as filed. Additional facts will be supplied as necessary.

I. Gross Income Tax—Interstate Commerce

DISCUSSION

Taxpayer argues that the restaurant-type sales were negotiated by out-of-state personnel and accordingly should not be subject to gross income tax. Taxpayer asserts that the sales in question were not connected to an Indiana business situs, and cites 45 IAC 1.1-3-3(c)(5) for the proposition that sales not connected with Taxpayer’s business situs should be exempt from gross income tax. That regulation states:

Gross income derived from the sale of tangible personal property in interstate commerce is not subject to the gross income tax if the sale is not completed in Indiana. The following examples are situations where a sale is not completed in Indiana prior to or after shipment in interstate commerce:

* * *

(5) A sale to an Indiana buyer by a nonresident with an in-state business situs or activities but the situs or activities are not significantly associated with the sale because it was initiated, negotiated, and serviced by out-of-state personnel, and the goods are shipped from out-of-state. The in-state business situs or activities will be considered significantly associated with the sale if the sale is initiated, negotiated, or serviced by in-state personnel.

Also of note is 45 IAC 1.1-3-3(d)(7), which states in relevant part

Gross income derived from the sale of tangible personal property in interstate commerce is subject to the gross income tax if the sale is completed in Indiana. The following examples are situations where a sale is completed in Indiana prior to or after shipment in interstate commerce:

* * *

- (7) A sale to an Indiana buyer by a nonresident seller if the sale:
- (A) originated from;
 - (B) was channeled through; or
 - (C) was otherwise connected with;
- an Indiana business situs established by the seller.

As noted in the audit report, Taxpayer has several locations in Indiana, which gave Taxpayer an Indiana business situs. These locations include sales offices, delivery stations, and retail stores. Taxpayer has not provided sufficient information to conclude that the sales in controversy for gross income tax purposes were not associated with Taxpayer's Indiana business situs.

FINDING

Taxpayer's protest is denied.

II. Adjusted Gross Income Tax—Royalty Expense

DISCUSSION

Taxpayer argues that the expenses for royalties paid to TP Brands should be permitted for 2001 and 2002. In particular, Taxpayer notes that the auditor indicated that the assessment was made pursuant to Ind. Code § 6-3-2-2(*l*). Taxpayer states that this section deals with apportionment and allocation rather than the disallowance of deductions. Taxpayer notes that Ind. Code § 6-3-2-2(*m*) is a more appropriate section for the rationale of the Department's assessment. The Department agrees that subsection (*m*) is more appropriate than subsection (*l*) for the disallowance of deductions.

Taxpayer argues that the Department's conclusion—that disallowing the deduction for payments from Taxpayer to TP Brands more fairly reflected Taxpayer's Indiana income—was erroneous.

First, Taxpayer claimed deductions of almost \$76,000,000 in royalties for 2001 and 2002. Taxpayer's income—taking into account the royalty payments—was \$4,000,000 for 2001 and a net *loss* of \$5,000,000 for 2002. Taxpayer and TP Brands' shareholders—the identical shareholders—are in exactly the same position as if Taxpayer had earned a \$75,000,000 profit. In summary, Taxpayer operated a business that *generated* a net profit of \$75,000,000, but *reported* a net loss for tax purposes by virtue of a claimed deduction for royalties to a related party. The arbitrary reduction of income leads to a conclusion that Taxpayer's income was not fairly reflected in its returns as filed, and the Department's disallowance of the royalty deductions for payments to TP Brands more fairly reflected Taxpayer's Indiana income.

Second, Taxpayer argues that the arrangement between Taxpayer and TP Brands had a valid business purpose and substance beyond simply garnering tax benefits. At the hearing, Taxpayer's representative indicated that the Department had not provided notice or guidance

with respect to the issue of royalty or intangible income expenses. The Department's auditor sent correspondence to Taxpayer on November 11, 2004. In relevant part, the request for additional information (page 16 of the Department's audit report) requested the following (grammar and punctuation in original):

2. Who are royalties paid to and what for. Where is the recipient of the royalty fees located and what business activities are they engaged in. How is the dollar amount of the royalty fee determined?
3. Who owns [Taxpayer] trademarks? [TP Brands]. Who is responsible for the expense of maintaining and defending the trademarks?

On February 18, 2005, the Department's auditor sent additional information (page 17 of the audit report) requesting the following (grammar and punctuation in original):

1. What are the royalty fees paid for? Specifically, what do any trademarks or intellectual property held by [TP Brands] relate to? Who developed any trademarks, trade names, patents, etc.?
2. Are the royalty fees pursuant to a licensing agreement? May I please have a copy of this agreement?
3. How and by whom was the amount of the royalty fees determined? How was the value of the intellectual properties determined?
4. I need to know the history of the trademarks and the companies holding them. When and how was [TP Brands] formed? Explain the transactions involved in the formation of this company. Through what transactions did [TP Brands] acquire any intellectual property? Who held the marks prior to the formation of the company currently holding them? Has [Taxpayer] always paid royalty fees for the use of the trademarks? Did [Taxpayer] pay royalty fees prior to [TP Brands]?
5. What is the business purpose of [TP Brands]? What activities does this holding company engage in? What activities does it engaged in related to intellectual property? Is it involved in creating, enhancing, or protecting intellectual properties? How many employees and officers are there and where are they located. What are the employee's and officers' responsibilities? What property does the holding company have. Does the holding company loan money to affiliates. If so, to whom and how much and for what interest charge? Are loan contracts available? What intellectual property does the company hold. Please provide a recent annual financial statement for [TP Brands].

Finally, on July 22, 2005, the Department auditor submitted a final request to Taxpayer for information to be submitted in the final audit report due August 9, 2005. In relevant part, the letter (pages 18 and 19 of the audit report) stated (grammar and punctuation in original):

- A. Are there inter-company royalty charges?
 1. Who holds the patent and/or trademark?
 - a. Is it a domestic (U.S.) company?
 - b. Is it a foreign operating company?
 2. Who developed the patent and/or trademark?

3. For what are the patent and/or trademark?
 4. How was the value of the patent and/or trademark determined? By whom?
 5. How were the patent and/or trademark transferred?
 6. When were the patent and/or trademark transferred?
 7. Who determined the basis on which to charge royalties and the rate to be charged?
- B. Is any income received by the royalty receiving company from unrelated parties? If so,
1. Is it from royalty payments?
 2. Is it interest?
- C. Does the royalty receiving company have any employees?
1. What are their duties?
 2. Who are the officers?
 3. Who pays the employees?
 4. Who makes the day-to-day operating decisions?
- D. Who handles the administrative functions (maintains books and records, prepares financials, prepares tax returns) for the royalty receiving company?
- E. Does the royalty receiving company have property other than the patent and/or trademark? If so, what?
- F. Income from patent and/or trademark
1. What does the royalty receiving company do with the income generated by the patent and/or trademark?
 - a. Research and development?
 - b. Protecting the patent and/or trademark?
 - c. Patent and/or trademark litigation?
 2. Is the income returned to the royalty paying company?
 - a. Inter-company loans?
 - i. Is there a loan agreement?
 - ii. What rate of interest is charged?
 - iii. Are periodic payments made on this loan?
 - b. Dividends?
 3. Are loans made to unrelated third parties?

The auditor further requested the following information in the July 22, 2005, letter:

- A. Minutes of Board of Directors meeting regarding the formation of the royalty receiving company and minutes from meeting concerning the original issue of company's stock.
- B. Copy of independent appraisers report determining the value of the patent and/or trademark
- C. Copy of Royalty Agreement
- D. Copy of all inter-company loan agreements, notes receivable and revolving credit lines.

- E. Names, titles and social security numbers of the officers of the royalty receiving company.

Taxpayer never provided this information to the Department despite three requests. At the hearing on March 22, 2006, Taxpayer's representative protested that Taxpayer did not know what information would be considered sufficient to prove their case, notwithstanding the prior correspondence referenced above. The Department's hearing officer reiterated the requests for information, and Taxpayer's representative indicated that Taxpayer would attempt to supply the information by the end of that business day. Taxpayer did not provide any documentation requested by the hearing officer.

Furthermore, the Department attempted to search federal records for intellectual property that might be held by TP Brands. There were no records associated with TP Brands' name; however, Taxpayer's name showed up repeatedly as owner of various items of intellectual property.

The lack of documentation of the royalty arrangement, lack of identifiable intellectual property, along with payments of \$76,000,000 to an entity in a state where Taxpayer has neither a store or even sales (but which state does not impose an income tax on the income of TP Brands), lend further weight to the conclusion that the deductions for royalties paid by Taxpayer to TP Brands were properly disallowed.

With respect to the disallowance of net operating loss carryforwards, the Department is not seeking to reassess the years 1998 to 2000. The Department is seeking to assess 2001 and 2002, and the redetermination of net operating loss carryforwards from 1998 to 2000 is necessary to permit the correct computation of tax for 2001 and 2002. Accordingly, Taxpayer's protest is denied with respect to net operating loss carryforwards from 1998 to 2000.

FINDING

Taxpayer's protest is denied.

III. Tax Administration--Negligence Penalty

DISCUSSION

Taxpayer protests the imposition of penalties under Ind. Code § 6-8.1-10-2.1 for failure to make sufficient estimated payments of tax, as required by Ind. Code § 6-3-4-4.1. Taxpayer argues that the failure to make estimated payments of tax due based on the amount of tax determined due by the Department. Other than an assertion that the penalty is the imposition of a "double penalty," Taxpayer has not sufficiently developed this argument, and accordingly is denied.

FINDING

Taxpayer's protest is denied.